No. 80

IN THE

Supreme Court of the United States

OCTOBER TERM, 1958

THE MONTANA POWER COMPANY,
Petitioner,

v.

UNITED STATES OF AMERICA,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF CLAIMS

REPLY TO RESPONDENT'S BRIEF IN OPPOSITION

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1. Respondent in its Brief in Opposition takes the position that the decision below by the United States Court of Claims is in conflict neither with the decision of this Court in *United States* v. *Kirby Lumber Co.*, 284 U. S. 1 (1931) (Br. 9-10), nor with the decision of the United States Court of Appeals for the Third Circuit in *American Smelting & Refining Company* v. *United States*, 130 F. 2d 883 (1942) (Br. 10-12). To the contrary it is submitted that the Court of Claim's decision is in conflict with the principle enunciated in both of these cases although the conflict with the latter may be more apparent than the conflict with the former.

This principle is that where a taxpayer has an increase or decrease in net worth in consequence of a borrowing and repayment transaction, such taxpayer realizes taxable gain or loss. The measurement of such gain or loss requires consideration of three elements where indebtedness is issued for property: (1) the principal amount of the indebtedness, (2) the value assigned to the property for tax purposes, and (3) the amount paid in satisfaction of the indebtedness.

In *Kirby Lumber Company*, elements (1) and (2) were the same, but element (3) was an amount lower than (1) and (2). Assuming hypothetical amounts: the amount of indebtedness was $1,000; the value assigned to the property (cash in this case) for tax purposes was $1,000; and the amount paid in satisfaction for the indebtedness was $900. As a consequence the taxpayer there realized a gain in net worth in the amount of $100 which this Court held to be taxable.

In *American Smelting & Refining Co.* elements (1) and (3) were the same, but element (2) was less. Assuming hypothetical amounts: the amount of the indebtedness was $1,000; the value of the property (stock of a subsidiary corporation) for tax purposes was $900; and the amount paid in satisfaction of the indebtedness was $1,000. As a consequence the taxpayer realized a loss in net worth which the Court of Appeals for the Third Circuit held to be deductible ratably over the life of the obligation of indebtedness.

In the present case, elements (1) and (3) were the same, but element (2) was less as in the case of *American Smelting & Refining Co.* Consequently it is submitted that the taxpayer realized a deductible loss.

The Court of Claims in its decision below held that regardless of whether the value of the property for tax purposes (element (2)) was fair market value at the time

that the indebtedness was incurred or the tax basis of the property at such time, the taxpayer realized no deductible loss when the indebtedness was paid (Pet. 6a). In so holding, the Court of Claims rendered a decision in conflict with the principle enunciated in both *United States* v. *Kirby Lumber Co.*, *supra*, and *American Smelting & Refining Company* v. *United States*, *supra*. Moreover by specific statement the Court below recognized its repudiation of *American Smelting & Refining Company* (Pet. 6a).

2. Respondent in its Brief in Opposition takes the position that the decision by the Court of Claims in the case below is clearly correct (Br. 7-9). The respondent's basic contention is that taxpayer issued its debentures in exchange for property in a nontaxable reorganization, and therefore it must forever suffer the consequences of this nontaxable exchange even though it subsequently paid off the debentures in full with cash.

However as pointed out by this Court in *Claridge Apartments Company* v. *Commissioner of Internal Revenue*, 323 U. S. 141 (1944) the general purpose of the reorganization provisions of the Revenue Acts was not to eliminate forever the tax consequences which might otherwise ensue upon transactions to which such reorganization provisions were applicable, but instead was merely to postpone such tax consequences. Mr. Justice Rutledge, speaking for the Court, said:

> "Accordingly, the succession of statutes relating to this field prior to §§268 and 270, represents a series of shifts in the legislative pendulum from initial broad tax relief, to encourage needed reorganizations, toward narrowed exemption, in order to discourage use of reorganization for evasion of taxes. The general purpose of the provisions, however, was to postpone the tax consequences which

> otherwise might ensue upon transactions occurring in such circumstances that immediate imposition was regarded as economically unjustifiable. This continued in the 1934 general revision, which remained in effect during the period of this litigation." (Footnotes omitted, 323 U. S. 141, 147.)

The transaction in 1936 in which taxpayer issued its debentures in exchange for property was a nontaxable reorganization solely because it exchanged its debentures for property rather than paying cash for such property; see Revenue Act of 1936 Sections 112(b)(4) and 112(g)(1)(C) (Pet. 22a). It is submitted that when taxpayer paid off these debentures in full with cash in 1945, the reason for postponing the tax consequences of this transaction was terminated, and the taxpayer then became subjected to the tax consequence of the entire and completed transaction, *i.e.*, the issuance of indebtedness in exchange for property and the ultimate payment of such indebtedness.

The Government's error, and evidently that of the Court below, is in failing to recognize that in a reorganization transaction, as here, involving issuance of indebtedness in exchange for property there is potential gain or loss as to *both* sides of the transaction. This is clearly shown at page 8 of its Brief where the postponement of gain incident to acquisition of transferor's basis of property is stressed, but no mention is made of the loss suffered where the indebtedness affecting such property was liquidated by cash payment in amount exceeding its issue price *i.e.*, the basis of the property acquired. Since upon the entire transaction the taxpayer suffered a decrease in its net worth on a tax basis, it is entitled to deduct the tax loss reflecting such decrease. This is precisely the situation considered by this Court in *Kirby*

Lumber Company. The essence of the *Kirby Lumber Company* decision is found in the sentence:

> "As a result of its [plaintiff's] dealings it made available $137,521.30 assets previously offset by the obligation of bonds now extinct." (284 U. S. 1, 3)

The above sentence in paraphrase demonstrates plaintiff's position here with crystal clarity, thus:

> As a result of plaintiff's dealings it ceased to have available $3,545,355.56 of assets (cash) previously offset by the obligation of bonds now extinct.
>
> The "previous offset" here involved can be shown:
>
> | | |
> |---|---|
> | Property (tax basis) | $7,044,544.44 |
> | Cash | 3,545,355.56 |
> | Debentures | $10,589,900.00 |

Furthermore the postponed gain in the reorganization stressed in the Government's brief (Br. 8), was not that of the taxpayer here. It was a postponed gain to taxpayer's transferor. Certainly two identical items of postponed gain to two separate taxpayers cannot attach to the same transaction. In point of fact and as here shown the taxpayer's position in the reorganization transaction is that of a postponed loss.

3. Respondent in its Brief in Opposition takes the position that this case involves essentially the same question as was presented in *The Montana Power Company* v. *United States*, 232 F. 2d 541 (3rd Cir. 1956) certiorari denied 352 U. S. 873 (1956) (Br. 6-7). This is essentially an argument that taxpayer is collaterally estopped from

bringing this action. The Court of Claims in its decision below did not expressly rule on this issue, although Judge Madden, speaking for the Court, said "Our impression is that the doctrine of collateral estoppel is not applicable, but, as will appear hereinafter, we decide the case on other grounds" (Pet. 4a).

It is submitted that the doctrine of collateral estoppel is not applicable. The case before the Circuit Court of Appeals for the Third Circuit involved the calendar years 1940 and 1941 (Pet. 4). Subsequent to those years a significant change occurred in the material facts which was not relevant in the earlier case, *i.e.*, the taxpayer in 1945 paid off its debentures in full with cash. This is the material fact that terminated the effect of the reorganization transaction and placed taxpayer in the position in which it realized a decrease in its net worth resulting in a deductible loss. As Mr. Justice Murphy, speaking for this Court in *Commissioner of Internal Revenue* v. *Joseph Sunnen*, 333 U. S. 591 (1948) pointed out,

> "But collateral estoppel is a doctrine capable of being applied so as to avoid an undue disparity in the impact of income tax liability. A taxpayer may secure a judicial determination of a particular tax matter, a matter which may recur without substantial variation for some years thereafter. But a subsequent modification of the significant facts or a change or development in the controlling legal principles may make that determination obsolete or erroneous, at least for future purposes. • • •" (333 U. S. 591, 599).

Therefore, it is submitted that this case does not essentially involve a question upon which this Court has previously refused to grant certiorari to the Court of Appeals for the Third Circuit.

For the reasons stated in its petition and in this reply to respondent's Brief in Opposition, it is urged that this petition for a writ of certiorari be granted.

Respectfully submitted,

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